

FAIR POLITICAL PRACTICES COMMISSION

Memorandum

To: Chairman Getman and Commissioners Downey, Knox and Swanson

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Subject: Pre-notice Discussion of Conflict of Interest Regulation: Materiality Standards for Indirectly Involved Business Entities (Amendment of Regulation 18705.1)

Date: August 22, 2002

I. OVERVIEW

Regulation 18705.1 defines what constitutes a decision's material financial effect on indirectly involved business entities. It does so by ranking business entities in four tiers of descending size and defines as material different dollar impacts on gross revenues, expenses, and assets or liabilities, for each tier. These tiers are:

- (1) listed among the Fortune 500,
- (2) listed, **or meeting the financial criteria to be listed** (emphasis added), on the New York Stock Exchange ("NYSE"),
- (3) listed, **or meeting the financial criteria to be listed** (emphasis added), on the American Stock Exchange ("AMEX") or NASDAQ, and
- (4) entities not meeting any of the foregoing.

In addition, the regulation uses this alternative "**or meets the financial criteria for listing**" standard in the exception at regulation 18705.1(b)(2). This exception applies to a public official whose sole economic interest in a business entity directly involved in a governmental decision (i.e. the applicant or subject of the decision), is an investment worth \$25,000 or less. In such a case, the public official may use the indirectly involved materiality standards to determine whether he or she has a conflict of interest in decisions foreseeably affecting that business entity.

The proposed amendments to regulation 18705.1 respond to public concerns with the alternative ranking standard "**or meets the financial criteria for listing.**" These concerns are generally threefold: discerning which of an exchange's listing criteria are the financial listing criteria, obtaining access to a business entity's financial information, and applying the financial information to determine whether an exchange's financial listing criteria have been met. The purpose of this alternative standard is to apply the same materiality standard to both publicly-traded and private business entities of the

same or similar size. Thus, the proposed amendments are narrowly directed to the alternative ranking standard in the second and third tiers and to the small investment exception, where this alternative ranking standard is also employed. In addition, two additional terms are defined and subdivision (d) of the regulation is amended to reflect these definitions.

II. HISTORY

The earliest ancestor of this regulation appeared in 1976 (as then-regulation 18702(b)(1)) and posed the question whether, in light of all the circumstances, the financial effect of the decision on a public official's investment in, or status with, a business entity, would lead to actual or apparent bias on the part of the official. Under this **"bias" standard**, numeric assessments, stated as percentage impact on annualized gross revenue, net income, and assets and liabilities, were tools to help indicate bias, but were not in themselves determinative of bias.¹

The above approach remained in place, with certain technical updates, until 1985, when regulation 18702 was amended and regulation 18702.2 was adopted. These regulations began to differentiate materiality according to the size of the business entity. Six tiers of size were created and first use was made of the exchanges and Fortune 500 as factors for placing business entities within the tier structure. Significantly, certain tiers were reserved for business entities that were not listed on the exchanges, but met the "financial standards for listing" on an exchange. At each reference to "financial standards for listing," the regulation identified the listing standards and provided the exchange's eligibility threshold for listing under a particular financial standard. The defined financial standards were net tangible assets, pre-tax income, and, with respect to NASDAQ (National Market), also net income.

The substantive provisions of the 1985 amendments remained in place, with minor changes, up to and through the Phase One Conflict of Interest Regulations Improvement Project. Phase One changes, effective in November of 1998, restructured the conflict-of-interest regulations to their present format, but made no substantive changes to the business entity materiality regulation (renumbered from 18702.2 to regulation 18705.1). Substantive changes transpired when Phase 2 of that project went into effect in February of 2001. Phase 2 repealed former regulation 18705.1 and substituted in its place new regulation 18705.1, in its current substance and format. Chiefly, the Phase 2 amendments:

- (1) Reduced the number of tiers from seven to four;
- (2) Substituted "meets the financial criteria for listing" in place of the former "financial standards" language, and eliminated language defining the exchanges' financial standards and associated eligibility thresholds;
- (3) Added definitions for certain financial terms used in the regulation; and

¹ Eventually the concept of using percentages as a numeric value instead of a stated dollar threshold was dropped due to the public's difficulty in obtaining a company's financial information necessary to make these calculations.

- (4) Added “safe harbor” language entitling public officials to rely, in certain circumstances, on a business entity’s most recent independently audited financial statements.

A chart tracing the development of the materiality standard from origin to its current form is included at Appendix A to this memorandum.

III. PROPOSED AMENDMENTS

The decision before the Commission is whether to:

- (1) retain the current language and amend the regulation to include definitions of the “financial criteria for listing” used by the various exchanges, or
- (2) substitute in place of the current reference to financial listing criteria one or two specific financial listing criteria and their associated eligibility thresholds.

For example, under (1) above, the financial criteria for listing on NASDAQ would be defined to include earnings before taxes of \$1,000,000 or more in the last fiscal year, or two of the last three fiscal years; or total revenue of \$75 million or more when market capitalization is \$75 million or more, or total revenue of \$50 million or more when market capitalization is between \$50 million and \$75 million (National Market). NASDAQ financial listing criteria also include net income of either \$750,000 or more, or \$500,000 or more in the last fiscal year, or two of the last three fiscal years (SmallCap Market).

Under (2), in place of the above definition, net income of no less than \$500,000 or earnings before taxes of less than \$750,000 would be substituted in place of “or meets the financial criteria for listing on NASDAQ.”

Option 1 above leaves the current language of regulation 18705.1 unaltered, but would add a number of definitions to subdivision (d) of the regulation defining what is meant by “financial criteria for listing” on the three exchanges. The principal benefit of this decision is that it maintains the present analytical framework of the regulation, thus avoiding public confusion that is inherent to some degree when changing analytical models. Another benefit of this decision is that it ensures equitable treatment for comparably-sized business entities. Listed and non-listed companies with comparable economic activity will be held to same materiality standard.

The downside of Option 1 is that it does not resolve the public’s concern with regard to acquiring and applying financial data to determine within which tier a business entity is to be placed. There is a plethora of possible means by which a business entity may have acquired or is maintaining its listing on an exchange. Some of these involve financial averages over a three-year period. The multiplicity of these options and the multi-year periods that can be involved make it both difficult and burdensome to apply the current regulation. Option 1 does not relieve this burden nor simplify the process of

determining whether a decision will have a reasonably foreseeable financial effect exceeding a materiality threshold.

To draft regulatory language depicting Option 1 is an extensive undertaking requiring the Commission's prior guidance on multiple decisions. There is no single set of listing criteria that constitute an exchange's listing criteria, let alone a bright line definition of what constitutes financial and non-financial listing criteria. For instance, the NYSE differentiates in its listing criteria between U.S. and foreign-domiciled business entities. In addition, there are three alternate sets of criteria for obtaining initial listing on the NYSE and two alternate sets of criteria for maintaining a listing. The AMEX and NASDAQ also have alternate listing criteria. **A series of charts showing the matrix of listing criteria for the three exchanges is provided at Appendix B.** For these reasons, regulatory language depicting Option 1 is not included with this memorandum.

Option 2 would, in essence, return to the 1985 alternative ranking standard. Like the 1985 regulation, the proposed ranking factors are earnings before taxes (equivalent to the former "pre-tax income") and net income.² Other economic criteria used by the exchanges to obtain or retain listing, such as multi-year averages and operating cash flow, are not used, just as they were not used in the 1985 materiality regulation. These criteria are impractical for public use because of the extensive amount of information required and the fact that the public would have to manipulate this information to arrive these criteria. Two improvements are offered when compared to the 1985 version of the materiality regulation:

- (1) The alternative ranking criteria "earnings before taxes" and "net income" would be defined in the regulation.
- (2) Under Option 2(b), below, the alternative ranking criterion would be an election of either: (a) a dollar amount specified in the regulation (similar to the 1985 version), or (b) such other amount as determined from time-to-time by the exchange (a self-adjusting threshold not contained in the 1985 version).

The advantage of Option 2 is that it states only one or two alternative ranking criteria, each of which is a reportable line item on a business entity's income statement. It is unnecessary for the public to undertake the burdensome process of examining a plethora of possible initial or continued listing criteria under multiple eligibility paths. (See Appendix B.) It is also unnecessary for the public to manipulate financial data in order to extrapolate a relevant criterion, as would be the case with net tangible assets or other listing criteria. In addition, each criterion is a single-year number, rather than a 3-year average. Finally, returning to a simplified form (four tier instead of seven tier) of the 1985 regulation puts into effect an approach with which the public has greater

² A 1985 listing criterion, "net tangible assets" is not used in the proposed amendments for two reasons. First, as of June 2001, NASDAQ no longer uses net tangible assets as a listing criterion. Second, "net tangible assets" is not a line item on an income statement or balance sheet, but is instead a calculated number requiring the public to manipulate financial data, including valuation of good will, in order to arrive at net tangible assets. This is one reason why NASDAQ recently eliminated net tangible assets as a listing criteria. (66 *Fed. Reg.* 131 at p. 35820 (July 9, 2001).)

familiarity. The 1985 materiality standard was in effect for approximately 16 years, whereas the current standard has been in effect for approximately 18 months. Option 2 resolves the public's concern for simplicity, specificity, and reliance on easily ascertainable financial data.

The downside to Option 2 is that the alternative ranking criteria will no longer embrace all of the financial criteria used by the exchanges to list member companies. For instance, NYSE has several alternative ranking methodologies that rely on a combination of market capitalization and operating cash flow, without regard to earnings before taxes or net income. Conceivably, listed and non-listed business entities with the same level of economic performance, as measured by earnings before taxes might, under the proposed version of regulation 18705.1, be placed in different tiers. For instance, net income or earnings before taxes might place a non-listed company in the NASDAQ/AMEX tier with a lower threshold of materiality, and a listed company with the same net income or earnings before taxes, but listed under the NYSE alternative global capitalization methodology would be retained in the higher, NYSE tier.

Similarly, Option 2 looks to a "snapshot" of economic performance over the most recent fiscal year, which is vulnerable to temporary aberrations in financial performance, economic downturns or upturns in the relevant industry, accounting rule changes or other non-repeatable events. In contrast, the NYSE looks to a three-year earnings base and both AMEX and NASDAQ value earnings for two of the most recent three years. Thus, one of the strengths of Option 2 - reducing the burden on the public by obligating the public to look at only one year's financial information - is also one of Option 2's vulnerabilities.

Option 2 selects earnings before taxes as the alternative ranking factor for Tier 2 (NYSE) and either earnings before taxes or net income for Tier 3 (AMEX/NASDAQ). Net income is not used as a ranking factor for Tier 2 since the NYSE does not use net income as a financial criterion for continued listing on that exchange. In both tiers, dollar thresholds are provided which correspond to current eligibility thresholds used by these exchanges. Option 2 is depicted in the chart below:

Option 2

Size of Business Entity	Related Exchange	Alternative Standard	Threshold Amount
Tier 2	NYSE	earnings before taxes	no less than \$2.5 million
Tier 3	AMEX, NASDAQ	earnings before taxes or net income	no less than \$750,000 or no less than \$500,000

The proposed amendments to regulation 18705.1 provide different ways to implement Option 2. The reason for these sub-options is to give the Commission the

choice to amend regulation 18705.1 in a manner that allows the alternative ranking criteria to “self-correct” for subsequent changes the exchanges may make in the dollar thresholds they assign for listing eligibility. The “self-correcting” option is shown as Option b in the chart below:

Options

Size of Business Entity	Related Exchange	Option 2(a)	Option 2(b)
Tier 1	NYSE	Earnings before taxes of no less than \$2.5 million	Earnings before taxes of no less than either (i) \$2.5 million or (ii) such other amount described at Rule 102.01C of the NYSE listed company manual, or any superseding rule of the NYSE.
Tier 2	AMEX, NASDAQ	Either earnings before taxes of no less than \$750,000 or net income of no less than \$500,000.	(A) Earnings before taxes of no less than either (i) \$750,000 or (ii) such other amount described under initial listing standard 1 of section 101(a) of the rules of the AMEX, or any superseding rule of the AMEX; or (B) (i) net income of no less than \$500,000 or (ii) such other amount described in the minimum financial requirements for continued listing on the NASDAQ SmallCap Market. ³

Option 2(a) implements Option 2 by substituting earnings before taxes and, with respect to NASDAQ, also net income, in place of “or meets the financial criteria for listing” language in the current small investor exception and the ranking criteria for tiers 2 and 3. The advantages and disadvantages of Option 2, above, are also ascribable to Option 2(a).

³ In the 1985 changes to the regulation, the NASDAQ National Market listing criteria was used. In the intervening years, the National Market continued listing criteria have grown to \$50 million in total revenue, placing these business entities on par with NYSE-listed business entities. The SmallCap Market, with a \$500,000 net income continued listing threshold, represents entities that would be too small to meet the NYSE listing criteria.

Option 2(b) is an election whereby a business entity may be characterized by a different tier if the relevant exchange has altered its listing eligibility dollar threshold to something other than its current amount, which is the amount stated explicitly in the proposed regulation. In practical application, this means that the regulation need not be amended each time an exchange changes its listing eligibility dollar threshold. The purpose of this election is to avoid a gap in time between when an exchange changes its listing eligibility thresholds and when the Commission can amend its regulation to reflect that change.⁴

Regulation 18705.1 also uses the “or meets the financial criteria for listing” language in the exception permitting public officials (who are small investors in larger business entities directly involved in a decision) to use the materiality standards for indirectly involved business entities.⁵ Options 2(a) and 2(b) are also applied to this exception. As a third option (denoted as Option 2(c) in the draft language), the Commission could delete the language “or meets the financial criteria for listing” language and allow the exception to apply only to small investments in Fortune 500 or NYSE-listed business entities.

Earnings before taxes and net income are defined in new subdivisions (d)(2) and (d)(6), respectively. These terms are not defined in Generally Accepted Accounting Principles and Generally Accepted Auditing Standards, but are used therein. The definitions offered are not inconsistent with the manner in which these terms are used in Generally Accepted Accounting Principles and Generally Accepted Auditing Standards, which fact is now noted in subdivision (d).

Finally, staff recommends inclusion of a “COMMENT” section to the regulation. The purpose of this addition is to provide the public with the webpage URL for the SEC’s searchable database of company filings (which the SEC refers to as “EDGAR”). Earnings before taxes and net income are separate line items on the income statements required to be filed with the SEC and accessible through this webpage. With adoption of Option 2(b), the “COMMENT” similarly provides the webpage URLs for accessing the NYSE, AMEX and NASDAQ current listing eligibility thresholds for earnings before taxes and, with respect to NASDAQ, net income. These webpage addresses could be provided to the public as hypertext links in the electronic version of regulation 18705.1

⁴ For example, if the NYSE were to increase its earnings before taxes eligibility threshold from \$2.5 million to \$3 million, a non-listed business entity with earnings before taxes of \$2.6 million, which under the proposed regulation would be placed in tier 2, and would remain in tier 2 until such time as the Commission amended this regulation. However, if NYSE were to drop the same threshold to \$2 million, a non-listed business entity with earnings before taxes of \$2.4 million, which would be placed at tier 3 under the proposed regulation, would be able to take advantage of the Option 2(b) election and obtain tier 2 status, even though not having earnings before taxes matching the amount of earnings before taxes stated in the regulation.

⁵ Subdivision 18705.1(b)(2): “Exception: If the public official’s only economic interest in the business entity is an investment interest (see Government Code section 87103(a)), and the public official’s investment in the business entity is worth \$25,000 or less, then apply the materiality standards in subdivision (c)(1) of this regulation if the business entity is listed on the Fortune 500, or the materiality standards in subdivision (c)(2) of this regulation if the business entity is listed, or meets the financial criteria for listing, on the New York Stock Exchange.”

posted on the Commission's website. Inasmuch as the "COMMENT" educates the public as to sources of relevant financial information, adding the "COMMENT" to regulation 18705.1 is appropriate to both Decision 1 and Decision 2. The "COMMENT" simplifies public access to relevant information and helps make Option b a practical alternative.

The downside to providing these links is that the links are vulnerable to future changes to the Internet addresses where this information is located. The Commission would be reliant upon these third parties to either not change the Internet addresses or, if the addresses change, to re-direct the user to the current Internet address where the information is located. However, since the links are described in a "Comment" to the regulation and not in the regulation itself, if the links become outdated it has no legal effect on the vitality of the regulation. The Commission may have to monitor and possibly amend the links in its "COMMENT" to reflect potential future changes. This could be accomplished, if required, as part of the annual technical "clean-up" of the Commission's regulations.

IV. PUBLIC COMMENT

An Interested Persons meeting was held on July 12, 2002, to address changes to this and other conflict-of-interest regulations. No members of the public attended or participated by telephone for the purpose of commenting on this regulation. No written comments were received by the Commission prior to, or after, the Interested Persons meeting. However, prior to the meeting telephone comments were obtained from CalPERS and California League of Cities:

CalPERS stated that there are too many tiers in the current regulation. While supporting a tier exclusive to Fortune 500 companies, CalPERS suggested that the remaining tiers be simplified, perhaps reduced to just one.

CalPERS believes the regulation should differentiate between publicly-traded business entities and private business entities. The size of the former should be measured by market capitalization and the size of the latter can be measured by the alternate ranking standard, albeit with higher thresholds to determine whether an effect is material.

With respect to the \$25,000 small investment exception allowing use of the indirectly involved materiality standards, CalPERS claims that \$25,000 is too low. They suggest that a sliding scale be used to set the exception threshold: the higher the value of a company, the greater the permitted level of investment under the exception.

The California League of Cities expressed that current regulation 18705.1 is not "user friendly" in that it is not easy to obtain the information necessary to learn where a business entity is to be placed among the tiers. It was suggested that the Commission should "figure out" the financial listing criteria for NYSE and NASDAQ and provide that information to the public, perhaps through a posting on the Commission's website. In addition, the League of Cities finds the present standards unreasonable. The League of Cities observed that there are large business entities listed on NASDAQ with greater

market capitalization than NYSE-listed entities, yet, the NASDAQ-listed entities have a smaller threshold for measuring materiality than NYSE-listed business entities.

V. STAFF RECOMMENDATION

Staff recommends Option 2(b). Staff also recommends the Commission adopt the proposed “COMMENT” which is suitable to either Option 1 or Option 2(a) or (b). Staff also recommends that the Internet addresses provided in the “COMMENT” be placed on the Commission’s webpage as links, and that staff be directed to explore maintaining these links as the regulation is disseminated for official reporting and listing with legal research organizations.

Attachments:

Amended Regulation 18705.1

Appendix A: charts depicting historical changes in the materiality standard

Appendix B: charts depicting NYSE, AMEX, and NASDAQ listing standards